Income Tax Treaties

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The United States-France Tax Convention*

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Much has been accomplished to alleviate double taxation since the 1932 convention between France and the United States.[1] Subsequent conventions[2] and supplemental protocols[3] were replaced in 1967 by what was for the United States the first thoroughly modern double taxation convention.[4] It was the first convention closely to follow the Organization of Economic Community Development [OECD] Draft Double Taxation Convention on Income and Capital of 1963[5] and to embody the amendments to the Internal Revenue Code introduced by the Foreign Investors Tax Act [FITA] of 1966.[6] Thus, until the publication of the U.S. Model Income Tax Treaty of May 18, 1976,[7] the 1967 convention with France was

1. April 27, 1932, T.S. No. 885.
2. July 25, 1939, T.S. No. 988.
3. October 18, 1946, T.I.A.S. No. 1982; June 22, 1956, T.I.A.S. No. 3844.
4. Signed July 28, 1967, T.I.A.S. No. 6518, effective January 1, 1967, hereinafter referred to as "the Convention" or "the Treaty."
5. Document C(63)87, hereinafter "the 1963 Draft." This draft was revised by the OECD in 1974; the revision will hereinafter be referred to as "the 1974 Draft."
6. Title I, P.L. 89-809, 80 Stat. 1539 (1966), hereinafter cited as "FITA."
7. P-H TAX TREATIES ¶ 1019.

regarded by the United States as something of a model in tax treaty negotiations.[8]

The convention follows the changed structure of U.S. taxation of foreign persons introduced by the FITA. Previously the Internal Revenue Code (IRC) and prior conventions applied the "force of attraction" principle. In other words, if a foreign person was engaged in trade or business in the United States, all of such taxpayer's income from U.S. sources was "attracted" to the U.S. trade or business regardless of the connection, if any, between the trade or business and the income so attracted. Thus, the entire taxpayer's income was taxed in the United States at regular rates and the foreign taxpayer could not take advantage of such lower treaty rates as might have been available on dividends, interest, or other types of passive income.[9] The elimination of this theory of taxation is the most important feature of the 1967 convention with France.

The 1967 convention, following the 1963 Draft, substituted the concept of "effectively connected." Now unless the investment income is effectively connected with a permanent establishment, such income will continue to enjoy the reduced rates of taxation applicable to it.

The following analysis will focus on some of the more frequently encountered tax consequences of commercial relations and investment between France and the United States. It will first set forth the general rules of taxation obtaining under the convention, and second, analyze the various types of income and their taxation under the convention.

8. *Cf.* Statement of Edwin S. Cohen, Asst. Secretary of the Treasury for Tax Policy, before Senate Foreign Relations Comm., Oct. 6, 1970, at ***Hearings for the Ratification of the Tax Conventions with Belgium, Finland, and Trinidad and Tobago***, Executive I., at 91-2; E, 91-2; and D, 91-2, respectively, 91st Cong., 2d Sess., at 26.
9. *Cf., e.g.*, Roberts, ***The Force of Attraction Doctrine in the United States Tax Law Today***, 21 B.I.F.D. 487 (1967).

I. General Tax Rules

The general rule of allocation of the taxing power between the United States and France is set forth in article 22(2) of the convention stating:

> (2) a resident of one of the Contracting States shall be taxed by the other Contracting State only on
>
> (a) commercial or industrial profits attributable to a permanent establishment located in that other Contracting State, and
> (b) income from sources within that other Contracting State, in accordance with the limitations set forth in the present Convention.

To determine the applicability of the convention the answer to certain threshold questions must be sought:

- is the person a resident of either France or the United States?;
- does the income have its source in either state?;
- what type of income is it?; and
- is there a permanent establishment to which the income might be attributable?

We now examine each of the jurisdictional bases for taxation or allocation of the taxing power between France and the United States.

A. Residence

1. Corporations

According to articles 3(1)(a) and 3(2)(a), a corporation is a "resident" of France or of the United States respectively if it is a

"French" or a "U.S." corporation. Such terms are defined at article 2(1)(d)(i) and (ii) as meaning any entity, in the case of the United States, organized in the United States and taxable as a corporation under U.S. tax law, and, in the case of France, treated as a body corporate under French tax law and resident of France for tax purposes. In *Compagnie Financière de Suez et de l'Union Parisienne v. U.S.* (33 AFTR 2d 74-769), it was ruled that an Egyptian corporation having its corporate administrative domicile in France since 1854, the majority of its shareholders French, was not a "French" corporation for reduced withholding purposes as its principal source of business income was Egypt and as it held itself out as an Egyptian corporation and never paid French income taxes.

2. Individuals

An individual, according to article 3(1)(b), is a resident of France if he is treated as such under French tax law. The French Tax Code[10] defines resident as anyone who has either

- a dwelling in France which he owns or has rented for more than one year; or
- made France his principal house although he does not have a dwelling in France.

The type of dwelling is irrelevant. It may be a house, an apartment, or a rented hotel room. Only the permanency of the dwelling is considered.[11]

An individual, according to article 3(2)(b), is a resident of the United States if he is so considered under U.S. tax law. The regulations promulgated under IRC § 871 distinguish between "residents"

10. Code General des Impots (CGI), art. 4-1.
11. Instructions May 27, 1969, Bulletin Officiel des Contributions Directes 1969. II 4530.

and "mere transients or sojourners." The determination of residence is a mixed question of fact and law, the resolution of which depends upon the intent of the taxpayer as it appears from the facts in the record.[12] Among others, the following facts have been considered: type of visa,[13] whether the taxpayer has his family with him,[14] whether his stay is voluntary,[15] the clubs he joins,[16] and the like.[17] Furthermore, in the case of the United States, a partner or fiduciary is taxed as a resident only to the extent that the income derived in the capacity of partner or fiduciary is taxed as that of a resident.

If an individual is found to be a resident of both France and the United States, then article 3(3) provides a mechanism for determining which State will have primary taxing jurisdiction over such taxpayer. One must first determine where the taxpayer's "permanent home" may be, *i.e.*, where he dwells with his family. If an individual has a permanent home in only one State, he is deemed a resident of that State only. If he has a permanent home in neither or in both, then one must inquire into his "centre d' interets vitaux" (center of vital interests), *i.e.*, where his personal and economic relations are closest. If he has such a center in both states or in neither, one must determine his place of "habitual abode," *i.e.*, the place where he resides most often, and, if he has one in both States, or neither, the competent authorities will determine the place of residence by mutual agreement.

12. Rolf Jamvold, 2 T.C. 122, 125 (1948), *acq.*, 1948-2 C.B. 2.
13. Treas. Reg. § 1.871-2(b); *cf.* Walter J. Baer, 6 T.C. 1195 (1946); Rudolph Jellivek, 38 T.C. 826 (1961), *acq.*, 1964-2, C.B. 6; Rev. Rul. 64-285, 1964 C.B. 184; *see also* Treas. Reg. § 1.871-4(c)(2)(iii).
14. *Cf.* Herman Baehre, 15 T.C. 236, *acq.*, 1951-1 C.B. 1; Downs v. Commissioner, 166 F.2d 504 (9th Cir. 1948), *cert. denied*, 334 U.S. 832 (1948); Grant Foster, 3 P-H TAX CT. MEM. ¶ 1389 (1965).
15. Rolf Jamvold, n. 12 *supra*.
16. Sochurek v. Commissioner, 300 F.2d 34 (7th Cir. 1962); Herman Baehre, n. 14 *supra*.
17. *See generally* S. ROBERTS & W. WARREN, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NONRESIDENT ALIENS ¶ IV/2 (P.L.I. 1966); hereinafter ROBERTS & WARREN.

B. CONTRACTING STATES

The convention (article 2(1)(a)) applies to metropolitan France and Guadeloupe, Guyana, Martinique, and Reunion, and to the states of the United States and the District of Columbia.

Query whether the continental shelf of the United States (or of France) is included in the definition of geographical United States? As the term "geographical United States" is not otherwise defined, article 2(2) states it shall have the meaning that it has under U.S. tax law. While at the time of signature of the convention, the IRC had no such definition, the Tax Reform Act of 1969 (IRC § 638) made it clear that the U.S. tax jurisdiction extended to the continental shelf insofar as income arising from exploration and exploitation of natural resources in the continental shelf is concerned.[18] Thus, a strong argument could be made that the continental shelf is included in the expression "geographical United States of America" as used in the convention.

C. PERMANENT ESTABLISHMENT

Following the pattern of the 1963 Draft, article 4 of the convention defines "permanent establishment" (PE) as either a "fixed place of business through which a resident of one of the Contracting States engages in industrial or commercial activity,"[19] with specific inclusions[20] and exclusions,[21] a specific kind of agency relationship,[22] or an express inclusion.[23]

18. Statement of Laurence N. Woodworth, Chief of Staff, Jt. Comm. on Internal Rev. Taxation, n. 8 *supra*, at 34.
19. Art. 4(1).
20. Art. 4(2).
21. Art. 4(3).
22. Art. 4(4), (5).
23. Art. 4(7).

1. Fixed Place of Business

The requirement for a "fixed place of business" is a very broad one. Items expressly included are a seat of management (siege de direction), branch, office, factory, workshop, warehouse, or mine, quarry, building site, or assembly project lasting more than twelve months. In addition, some older Revenue Rulings have held that while entering a horse in one race is not sufficient to qualify as a PE,[24] entering it in several may be sufficient under unspecified circumstances;[25] under these Rulings, a floor show constitutes a PE,[26] thus creating a kind of "peripatetic" fixed place of business concept. In *Georges Simenon*[27] the Tax Court ruled that the part of the house the author used to write constituted an "office" and thus gave rise to a permanent establishment.

Some items are specifically excluded. If a stock of goods of a resident of France is maintained in the United States for processing by another, this does not constitute a PE (article 4(3)(c)).

What amount of processing will be sufficient to prevent a finding of PE?[28] While there is no ready answer, some minimum degree of transformation of the goods or merchandise must take place beyond mere packaging. A comparison of processing with its equivalent transformation in the French version of the convention lends support to this contention.[29] By way of analogy, the use of a 20% value added test as under Reg. § 1.954-3(a)(4)(iii) and Reg. § 1.993-3(c)(2)(iv) can be suggested.

Article 4(3)(c) excludes such preparatory or auxiliary activities as "[t]he maintenance of a fixed place of business for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character

24. Rev. Rul. 58-63, 1958-1 C.B. 624.
25. Rev. Rul. 60-249, 1960-2 C.B. 264.
26. Rev. Rul. 67-231, 1967-2 C.B. 470.
27. 44 T.C. 820 (1965).
28. *Cf.* Belgium convention, art. 5(4).
29. *Accord.* German treaty equivalent, "bearbeitet oder verarbeitet."

for the resident." This provision, found in all U.S. conventions subsequent to the OECD draft of 1963, is by far the greatest source of escape from the designation as PE.

The rationale, and ramifications, of this exclusion are set forth in the OECD Commentary on article 3(e) of the OECD draft, the language of which closely parallels the above, which is well worth quoting at length:

> 12. Comment is perhaps called for on the examples mentioned in paragraph 3(e). It is recognised that a place of business the function of which is solely that of advertising, or the supply of information, or of scientific research may well contribute to the productivity of its parent enterprise. To assume so is once more axiomatic. But the services it performs for its parent enterprise are so far antecedent to the actual realisation of profits by its parent body that no profits can properly be allocated to it; accordingly it does not constitute a taxable unit. It should, of course, be emphasized that exemption should be given only so long as the place of business completely satisfies the conditions laid down. If for example, the research establishment were to concern itself with manufacture, then exemption would be forfeited.
>
> 13. The last words of sub-paragraph (4), "or for similar activities which have a preparatory or auxiliary character for the enterprise" require a special explanation of their own. The purpose of these words is twofold. In the first place, since it would be unreasonable to seek a claim that the list of examples quoted in paragraph 3 is, or in the nature of things could hope to be exhaustive, the last words of sub-paragraph (e) are intended to cover any further examples (such as the organisation maintained solely for the purposes of servicing a patent or "know how" contract) which are not listed among the exceptions in paragraph 3 but are nevertheless within the spirit of them. The words in question are, therefore, intended to

make it unnecessary to attempt to produce an exhaustive list of exceptions which, even if it were comprehensive, would inevitably be of inordinate length and undesirable rigidity. In the second place, the words extend the principle underlying the examples in sub-paragraph (e) to provide a generalised exception to the general definition in paragraph 1. To a considerable degree they delimit that definition and exclude from its rather wide scope a number of forms of business organisation which, although they are carried on in a fixed place of business, would not be treated as taxable units.

To put the matter in another way, the last words of sub-paragraph (e) refine the general definition in paragraph 1 and, when read with that paragraph provide a more selective test by which to determine what constitutes a properly taxable permanent establishment. In view of the examples given, the reference to "similar activities" cannot lead to an arbitrary extension of the exemption set out in paragraph 3(e). It will, of course, be the responsibility of the enterprise to prove that the activities in question are of a preparatory or auxiliary character within the framework of the whole activities of the enterprise. If, for example, the results of the research carried on in a laboratory are not only used by the enterprise but are also sold to a third party, the paragraph would cease to apply. Alternatively, it would be possible for countries to include in bilateral agreements a provision that, where the results of the laboratory's research are used partly by the enterprise and in part are sold to third parties, the charge to tax on the permanent establishment should be limited to the profits arising from the sales to third parties. Such a provision would be analogous to the provisions relating to "mere purchase" in a number of Conventions.[30]

30. Commentary on 1963 draft, art. 5(4).

Revenue Ruling 72-418,[31] issued under article II (1)(c) of the German convention, which contains the same language, shows how broad an exception to the rules of the PE the exclusion for "auxiliary or preparatory activity" may be. The Ruling explored the question of whether a German bank's U.S. representative office constituted a permanent establishment as being an "office" in which the business of the German enterprise was "wholly or partly carried on." The lease of the office space was in the name of the individual who acted as representative. The German bank maintained a bank account with a U.S. bank and the expenses of the representative's office were paid by checks drawn on such U.S. bank. The representative's office performed the following functions without fees: gathering information on various U.S. commercial and financial matters and reporting same to Germany; supplying U.S. companies with current information on business and financial conditions in Germany; supplying letters of introduction to its home office to obtain information as to repayment possibilities; advertising the bank in newspapers and by personal contacts. The bank's office did not buy, sell, pay, or collect bills of exchange, issue letters of credit, make loans, receive deposits, conclude any contracts on behalf of the bank, or solicit business on behalf of the bank. Under the circumstances, the IRS ruled that such an office came within the purview of the specific exclusion from the definition of permanent establishment under the convention.

A purchasing office of the resident[32] or of an agent of the resident whose sole authority is limited to purchasing[33] does not constitute a PE. It has been rightly suggested[34] that if some other activity, such as sorting, grading, etc., is performed by such a purchasing office, it ceases to fall within the purview of the specific exclusion.

Does the exclusion similarly apply to the office of a foreign in-

31. 1972-2 C.B. 661.
32. Art. 4(3)(d).
33. Art. 4(4)(a).
34. 1 KOCH, THE DOUBLE TAXATION CONVENTIONS 52 (1947).

vestment company used to purchase securities?[35] In other words, are "securities" to be deemed to be "goods or merchandise"?

The answer is probably negative since stocks and bonds are in the nature of legal rights, evidenced by certificates, and thus partake of a different essence than goods or merchandise, which are of a more tangible nature.[36]

Article 4(3)(d), introduced in the 1963 OECD draft,[37] excludes collection of information and seeks to cover the activities of new bureaus. It was viewed as no more than an extension of the concept of "mere purchase."[38] Presumably, the exclusion would also apply to, say, the office of a market research firm to carry out market research for its foreign home office. Query whether the exclusion would still apply if such an information collecting office were equipped with a computer terminal linked to the central data processing system of the home office abroad? The answer is probably affirmative since a computer terminal used to feed information into a system is not conceptually different from the teletypes of the newspaper bureaus. If, however, the market research firm were to sell to third parties the products of its research, then a PE would come into being.

2. Agency Requirement

Two kinds of agents are contemplated in the convention: "dependent agents" and "independent agents." The carrying on of a trade or business through dependent agents usually entails the creation of a permanent establishment; if carried on through independent agents, no such result ensues.

35. ROBERTS & WARREN, ¶ IX/12F(2)(a).
36. A court might yet follow the "dry goods" characterization of "securities" found in AUCHINCLOSS, POWERS OF ATTORNEY.
37. 1963 draft commentary, ¶ 11 at 74, in fine.
38. Art. 4(3)(b), (d). One may query, in passing, whether this concept of "mere purchase" could be applied to the case of the office solely buying securities, as discussed at text, n. 35 *supra*.

(a). *Dependent Agents.* A dependent agent gives rise to a PE if he has authority to contract or if he maintains substantial equipment. According to article 4(4)(a), a dependent agent will give rise to PE if he "has, and habitually exercises in that State, an authority to conclude contracts in the name of that resident." Two conditions must be present simultaneously for the PE label to attach: (1) existence of the authority to contract, and (2) habitual exercise of such authority. This language again bears the imprint of the 1963 OECD draft.[39]

In previous conventions, a good deal of confusion had been introduced by the use of the qualifiers "general agent" and "general authority to contract."[40] In recommending the change, adopted by the French convention, the OECD recognized that "[i]n practice, it seems unlikely that any dependent agents have a completely unfettered authority to conclude contracts. In all cases the authority must to some extent be circumscribed. For administrative reasons, it seems advisable to avoid the difficulties which would inevitably arise if the question of whether or not the dependent agent is a permanent establishment had to be decided by reference to the precise extent of his authority. When the agent has sufficient authority to bind the enterprise's participation in the business activity of the other country, the agent should be deemed to be a permanent establishment."[41] It appears then that the criterion of article 4(4)(a) of the convention is *legal* authority to bind the foreign principal. Power to vary contract terms or negotiate on behalf the principal is no longer determinative.

39. *Cf.* art. 5(3)(c).
40. *Cf., e.g.,* conventions with Australia, Canada, South Africa, Greece, Burundi, Denmark, Italy, New Zealand, Pakistan, and Switzerland. *See also* Rev. Rul. 55-282, 1955-1 C.B. 634 (discretionary power to sell securities); Donroy Ltd. v. United States, 196 F. Supp. 54 (N.D. Cal. 1961); ——, 301 F.2d 200 (9th Cir. 1962); Consolidated Premium Iron Ores Ltd., 28 T.C. 127 (1957), *nonacq.* 1958-1 C.B. 7, *aff'd*, 265 F.2d 320 (6th Cir. 1959); Elizabeth Herbert, 30 T.C. 26 (1958), *acq.* 1958-2 C.B. 6.
41. OECD Commentary § 16, at 75. After much discussion, the UN Group of Experts on Taxation Between Developed and Developing Countries also followed the same path.

Legal authority must be exercised habitually. In this respect the convention is not novel,[42] but consistent with the idea of continuity of activity underlying the concept of permanent establishment.[43] The case of *Elizabeth Herbert*,[44] decided under the then U.K. convention, illustrates the requirement of habitual use as well as the type of authority needed to give rise to a PE. In that case, the taxpayer, a resident of the United Kingdom, received rents from a Washington, D.C., building which she co-owned with her sister. She granted her sister, a New York resident, an unlimited power of attorney relating to any business or property matter which might arise. It was understood however that such power would not be used without prior consent or in case of emergency. The court did not hold this to constitute a permanent establishment. Actual authority and not its mere appearance is thus necessary to give rise to a permanent establishment.[45] Likewise, Revenue Ruling 55-282[46] held a Canadian investment corporation to have a permanent establishment in the United States since its agent there had discretionary power to buy and sell securities and to keep records in the United States. As pointed out, article 4(4)(a) carves out an exception for an agent whose sole authority is limited to purchasing contracts.[47]

Article 4(4)(b) stipulates that a dependent agent who "maintains substantial equipment or machinery . . . for a period of twelve months or more" shall be deemed to be a permanent establishment. This provision, on which the memorandum prepared by the staff of the Joint Committee on Internal Revenue Taxation remains silent, raises some difficult questions. How is the substantiality of the equipment to be measured, and in relation to what? When the text merely says "maintains," how relevant is the use of equipment?

42. All U.S. conventions except that with South Africa require the authority to be "regularly" or "habitually" exercised.
43. See n. 41 *supra*.
44. N. 40 *supra*.
45. *Accord*, Rev. Rul. 63-113, 1963-1 C.B. 410.
46. N. 40 *supra*.
47. See text at n. 32 *supra*.

Does it matter if the equipment is just in storage or if it is for rental? The provision is reminiscent of another condition ("maintains a stock of goods from which he regularly fills orders")[48] found in older conventions and which the OECD Fiscal Committee expressly decided not to include in the 1963 draft.[49] The Internal Revenue Code, at Regulation § 1.864-7(d)(1)(i), also includes dependent agents maintaining a stock of goods from which orders are filled in the definition of "office or fixed place of business," the Code equivalent of permanent establishment. However, as the convention with France otherwise relies so extensively on the OECD draft, another approach may be suggested. It can be argued that if a resident of one of the contracting states carries on any one or more of the activities contemplated at article 4(3)(a)-(e), not through the resident's own fixed place of business but through that of its dependent agent, then no permanent establishment should arise.[50] Thus, it can be argued, the maintenance of substantial equipment by a dependent agent will give rise to a PE if the purpose of such maintenance is not otherwise excluded under article 4(3)(a)-(d). Maintenance of machinery for rental would clearly not come within the ambit of any of the exclusions at article 4(3)(a)-(d), but would come within that of article 4(4)(b), giving rise to a permanent establishment.[51]

(b). *Independent Agents*. As is standard. article 5(5) states that no permanent establishment will arise if the business of the resident is carried on through an independent agent (such as a commission broker or consignee) acting in the ordinary course of his business.

An independent agent may be an exclusive agent acting exclusively or almost exclusively for the foreign principal. In such a case,

48. *Cf.*, *e.g.*, conventions with Australia, Canada, and South Africa.
49. Commentary on art. 5, ¶ 17 at 75-76.
50. *Accord*, U.S. Model Tax Treaty of May 18, 1977, art. 5(5).
51. Interestingly, art. 9 of the 1970 Convention with Trinidad and Tobago qualifies the maintenance to be "for rental or other purposes," thus lending support to the text argument.

the facts and circumstances have to be taken into account to determine if a permanent establishment exists.[52]

Query if the independent agent also has the authority to contract on behalf of the foreign principal. Is he to be classified as a dependent or as an independent agent? The text at article 4(4) defines "dependent agent" as "other than an agent of independent status to whom paragraph 5 applies." Thus, one may conclude that an independent agent having authority to contract does not constitute a permanent establishment.[53]

Both in the case of dependent agents and in that of independent ones, article 4(6) of the convention stipulates that the fact that the agent may be related within the meaning of article 8 (*e.g.*, a parent-subsidiary relationship) shall not be taken into account in determining whether a permanent establishment exists.

3. Specific Inclusions—Insurance Activities

Following a long tradition of special provisions on insurance,[54] the new French treaty at article 4(7) provides:

> An insurance company of one of the Contracting States shall be considered as having a permanent establishment in the other Contracting State if, through a representative other than one described in paragraph (5) [independent agent], such company receives premiums from or insures risks in the territory of that other Contracting State.

52. Treas. Reg. § 1.864-7(d)(3)(iii).
53. *See Joint Committee Memorandum on Conventions with Trinidad and Tobago, Japan, and Norway*, n. 8 *supra*, at 157, and on the conventions with Belgium and Finland, where the point is clearly made, n. 8 *supra*, at 123 and 142. *See also* Inez de Amodio, 34 T.C. 894 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962); Donroy Ltd., n. 40 *supra*; Rev. Rul. 56-594, 1956-2 C.B. 1126.
54. *See* ROBERTS & WARREN, ¶ IX/12 K(1), for an analysis of the insurance provisions in previous conventions.

An Exchange of Notes added:

> It is understood that when an insurance company of one of the Contracting States has a permanent establishment in the other Contracting State the reinsurance premiums received shall be taken into account for the determination of taxable profits only in the Contracting State of which the company is resident.[55]

The chief difficulty in connection with the foregoing provision lies in the determination of the degree of independence of the agent through whom the business is transacted. It can certainly be argued, as in the case of exclusive agents, that a general insurance agent who places, say, 80 percent of his business with one company is no longer truly independent.[56]

In the United States, at least, the status of general agents appears to be closer to that of dependent agent than to that of independent agent. Quite frequently the premises are rented by the company and the agent shares in the rent; he may hire his sub-agents but they must be approved by the company, and he may only place business with other companies if his company refuses it. No general consensus of what is an independent insurance agent seems to exist at present.[57] As pointed out by Roberts & Warren,[58] the provision does not mean that the receipt of premiums by a French enterprise will automatically result in U.S. taxation. As a treaty cannot impose a tax liability, the income must otherwise be taxable under the Code.[59]

55. Exchange of Notes, July 28, 1967, ¶ 4.
56. *Cf.* Lazerow, *The United States-French Income Tax Convention*, 39 FORDHAM L. REV. 649, 676-77 (1971).
57. UN Second Rep., n. 41 *supra*, ¶ 50 at 11.
58. ROBERTS & WARREN, ¶¶ IX/12K(1), VI/4(D)(3).
59. Contrast with art. 5(6) of the convention with Belgium.

4. Miscellaneous

(a). *Partnerships.* If a foreign partnership has a permanent establishment in the United States, the general rule is that each partner will be deemed to have a permanent establishment in the United States.[60] Probably erroneously,[61] the *Donroy* case[62] has extended this rule to limited partners.

(b). *Trusts.* There does not appear to be any support for the position that a beneficiary of a trust will have a permanent establishment merely because the trust has one.[63]

5. Summary

A permanent establishment will be created under article 4 of the Convention only if the following three elements are met simultaneously:

- continuity of activity during some, however brief, period of the taxable year;[64]
- a "fixed place of business" through which an "industrial or commercial" activity must be carried out (being engaged in trade or business alone is not sufficient to constitute a permanent establishment);[65]

60. W. C. Johnston, 24 T.C. 920 (1955).
61. *See* P. F. de Ravel d'Esclapon, *International Tax Treaties and Industrial and Commercial Profits*, at 90-91 *supra*, and in U.S. TAXATION OF INTERNATIONAL OPERATIONS ¶ 5005.4. (Prentice-Hall 1972) for a detailed critique of the result reached in *Donroy*.
62. Donroy Ltd. v. United States, 301 F.2d 200 (9th Cir. 1962).
63. *Cf.* ROBERTS & WARREN, ¶ IX/121 (2).
64. *See* Jordan, Bischel & Smith, 58a CAHIERS DE DROIT FISCAL INTERNATIONAL, II/95 at 103 (1973).
65. *See* White, *Does the Existence of a "Permanent Establishment Connote "Engaged in a Business"?*, 27 J. TAX. 176 (1967).

- the revenues so generated must be in the nature of "industrial or commercial profits,"[66] as defined in article 6(5).

D. TAXES COVERED

In the case of the United States, the convention applies to the U.S. federal income tax. In the case of France, it applies to the various French taxes including the payment ("précompte mobilier") and the tax on stock exchange transactions.[67]

As is customary, the convention applies not only to taxes presently imposed but also to similar taxes which may be imposed in the future.[68] Furthermore, the nondiscrimination provisions of article 24 apply to taxes imposed at the national as well as at the state or local level.[69]

E. OTHER GENERAL RULES

1. Relief from Double Taxation

Article 23 of the convention sets forth the rules designed to avoid double taxation.

In the case of the United States, article 23 reaffirms that taxes covered under the convention and paid to France are credited under

66. Thus, an office used to render services would not qualify as PE since this type of income is excluded from the definition of "industrial or commercial profits of a resident." Article 615. *Cf.* Convention with Norway of Dec. 3, 1971, art. 5(5), which defines the term "industrial or commercial activity" and excludes therefrom income derived from the performance of personal services by an individual either as an employee or in an independent capacity.
67. *See* Rev. Rul. 75-402, 1975-2 C.B. 511.
68. Art. 1(3).
69. Art. 1(4).

the usual foreign tax credit provisions of the Internal Revenue Code,[70] subject to the per country limitation.[71]

In the case of France, U.S. taxes paid are credited against French taxes due. France is also allowed to employ its exemption with progression method which provides that, though a particular item of income may be exempt in France or taxed at a reduced rate, such a particular income will nonetheless be taken into account to determine the applicable rate of tax.[72]

Last, article 23(3) provides that U.S. residents will not be charged with the French tax on imputed income[73] based on the rental value of a French abode or abodes.

2. Nondiscrimination

Article 24 of the convention provides that neither France nor the United States may impose more burdensome taxes on the residents of the other than on its own residents or citizens.[74]

The nondiscrimination principle is extended to permanent establishments of a resident,[75] as well as to corporations owned or controlled by residents of the other Contracting State.[76] In view of Rev. Rul. 75-131,[77] the nondiscrimination principle can be taken to apply also to a "fixed base" of a resident of the other State.

70. I.R.C. §§ 902 *et. seq.*
71. Of course, if the Internal Revenue Code allows overall limitation in a particular instance, and if a result more favorable to the taxpayer ensues, such benefit accrues to the taxpayer, regardless of the convention.
72. *Cf.* Art. 164.1 CGI. As France is considering the repeal of art. 164.1 CGI, representatives of the two governments met and agreed on their mutual interpretation of treaty provisions which can affect American taxpayers in France. *See* Treasury Department News Release WS 1196, Nov. 30, 1976.
73. Art. 164-2 CGI.
74. *See also* Rev. Rul. 72-330, 72-2 C.B. 444; Rev. Rul. 72-598, 72-2 C.B. 451.
75. Art. 24(2).
76. Art. 24(3).
77. 1975-1 C.B. 389.

3. Administrative Provisions

Article 25 provides for a mutual agreement procedure to resolve or attempt to resolve difficulties arising under the convention. Article 25(1) makes it clear that a taxpayer may seek relief under this procedure without first having to exhaust whatever remedies may be available under national law. As in all other conventions, article 25 does not require the competent authorities to arrive at a resolution of the issues submitted to them, but merely to endeavor to do so.[78]

The convention provides for two kinds of exchanges of information. Article 30 provides for the exchange of official information on laws, regulations, and cases dealing with the taxes covered by the convention. Article 26 relates to the carrying out of the purposes of the convention or the preventing or combating tax fraud or fiscal evasion subject to the usual international law reservation concerning the nonenforcement of the penal laws of one sovereign by another.

Pursuant to article 26, the two States undertake to lend assistance to each other in the collection of taxes to which the convention relates, provided the following conditions have been met: (a) the taxes and fines for which assistance is requested are not of a penal character under the laws of the State requested; (b) the taxes have finally been determined to be due under the laws of the requesting State.

4. Special Classes of Residents

The convention, at article 28, stipulates that diplomatic or consular officers shall not be affected by the convention.

For up to two years, visiting teachers engaged in teaching or in research at an accredited institution are exempt from tax in the

78. Art. 25(2).

host country. Income from research primarily undertaken for the benefit of private persons is not exempted.[79]

Under article 18(1)(b), students of accredited institutions are exempt from host country tax on income from the home country used for their maintenance, education, or research, any grants from governmental or charitable institutions, and the first $2,000 of annual income from personal services rendered in the host country.[80] However, such $2,000 yearly exemption together with the benefits of article 17 (teachers) is limited to a total of five years.

Trainees who are employed by a resident of the other Contracting State and who are present in the other state for study or for gaining experience are granted a one year tax exemption on the first $5,000 of personal service income (article 18(2)).

Following a long standing practice, article 8 provides for an allocation of income in the case of transaction between related persons, if such allocation is necessary to reflect whatever conditions or arrangement would have been arrived at between unrelated persons.[81]

II. Types of Income

A. Income from Real Property

For purposes of article 5, "income from real property" includes rents, income from usufruct, royalties on mines, quarries, and other types of natural resources extraction. Such income also includes capital gains arising from the sale or exchange of real property or of the right giving rise to the royalties. "Royalties" in this context means fixed or variable payments as consideration for the

79. Art. 17(2). *Compare* Rev. Rul. 77-175, 1977-1 C.B. 415, issued under Art. 19 of the U.S.-Japan Convention.
80. Such as income from a part-time job. *Cf.* art. 18(1)(b)(iii).
81. The provisions of art. 8 closely resemble those of I.R.C. § 482.

working of, or the right to work natural resources deposits.[82] The term, however, does not include income from debts secured by mortgage or other encumbrances on the realty.

"Real property" is a term the meaning of which is determined under the law of the situs. It will normally include the realty itself ("immeubles") and its appurtenant fixtures ("immeubles par destination"). An argument can be made that livestock and agricultural equipment should also be included in the concept of "real property."[83]

The state where the real property is situated has the right to tax income derived from such real property. However, article 5(3) allows taxpayers to elect to be taxed as if they were engaged in trade or business in the State of situs.[84] The effect of this election is to allow taxation of the real property income on a net basis, *i.e.*, offsetting deductions against the income, instead of on a gross basis.

B. Shipping and Air Transport Income

As an exception to the general treaty rule of articles 6 and 22, shipping and air transport income derived from ships or aircraft of international traffic is taxable only in the country of registry (article 7).

The advent of containerization has raised the question whether ancillary activities connected with containerization are "income from the operation of ships on international traffic." Such activities would typically be the supply of the containers and of the undercarriage for transportation at port of departure and of destination,

82. *Cf.* Rev. Rul. 73-419, 1973-2 C.B. 436, issued under the treaty with Switzerland, which held that "net Profit Interests" in oil and gas mineral properties were royalties.
83. *Cf., e.g.*, Art. 6(2) of the U.S. model treaty of May 18, 1977.
84. In the United States, the resident of France would make an election under I.R.C. § 871(d)(1).

the transfer of the containers from railway beds onto the ships, and unloading on trucks or railway beds. A Ruling[85] issued under article 5 of the U.S.-German convention, which uses the same language, has determined such ancillary activities to be "income from the operation of ships in international traffic."

C. Business Profits

Following the OECD draft of 1963, article 6 recognizes that, in the absence of a permanent establishment to which they are attributable, business profits are not taxable by the country of source.

While earlier treaties with other countries contained little or no definition of "business profits" or "industrial and commercial profits,"[86] the convention with France defines the terms as follows:

> (5) The term "industrial or commercial profits of a resident" includes income derived from manufacturing, mercantile, agricultural, fishing, or mining activities, from the operation of ships or aircraft, from the furnishing of personal services, from the rental of tangible personal property, and from insurance activities and rents or royalties derived from motion picture films, films or tapes of radio or television broadcasting. It also includes income derived from real property and natural resources and dividends, interest, royalties (as defined in paragraphs (3) and (4) of Article 11) and capital gains but only if the right or property giving rise to such income, dividends, interest, royalties or capital gains is effectively connected with a permanent establishment which the recipient, being

85. Rev. Rul. 74-92, 1974-1 C.B. 373.
86. The expression goes back to the first U.S.-France treaty of 1932 and was borrowed from the French "benefices industriels et commerciaux." For historical background on the efforts of various international organizations to grapple with the concept of "business profits," *see* P. F. de Ravel d'Esclapon, n. 62 *supra*.

> a resident of one Contracting State, has in the other Contracting State. It does not include income received by an individual as compensation for personal services either as an employee or in an independent capacity.

While the definition clarifies many earlier ambiguities, such as whether insurance profits[87] or royalties on radio or videotapes are "business profits," it has also raised some questions with respect to certain types of income considered below.

As the term "resident" is elsewhere defined as including both corporation and individuals, the definition allows the conclusion that the income of a corporation furnishing the personal services, *e.g.*, management consulting, is in the nature of "industrial or commercial profits," or, likewise, if an individual furnishes the services of his employees. This rule, however, does not apply if the individual himself renders the services.[88] As a result, individual taxpayers may seek to incorporate themselves to bypass the exclusion from "business profits" of services rendered by an individual himself. The validity of such attempts was faced in one case.[89]

In *Johannson v. United States*,[90] the Swedish boxer, prior to going to the United States to fight Floyd Patterson, formed a Swiss corporation and entered into an employment agreement with it.

87. The exchange of notes accompanying the convention indicate that reinsurance premiums will not be taxed by the county in which the permanent establishment is situated. Revenue Ruling 77-62, 1977-1 C.B. 414, has further clarified the phrase "reinsurance premiums" by including therein investment income derived in connection with the conduct of a reinsurance business in one of the Contracting States by an insurance company which is a resident of the other Contracting State.
88. See the section on personal service, *infra*, for a discussion of loan-out arrangements.
89. *See* Kander, *The Service Corporation as the Taxpayer's Alter Ego: Variations on the Borge Theme*, 28 N.Y.U. Inst. on Fed. Tax. 1109-43 (1969); Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970); Estate of Nathaniel Cole, 32 T.C.M. 313 (1973); Silver, *Use of Corporations by Executives and Professionals*, 1973 Corporate Management Tax Conf. 83, 92-95 (Can. Tax Foundation).
90. 336 F.2d 809, 814 (5th Cir. 1964).

The Court of Appeals for the Fifth Circuit, after stating that it was the intention of the parties to the treaty to promote international trade, held:

> International trade will not be seriously encumbered by our refusal to grant special tax treatment to one only marginally, if at all, a Swiss resident and only technically, if at all, employed by a paper Swiss corporation.

Given the blatantness of the sham, the above decision can hardly surprise. However, what would have happened if the Swiss company had a history of handling Johannson's fight arrangements and also had been used by him as an investment vehicle? Quite probably, it would have withstood the IRS attack.

The Convention, at article 2(4)(a), defines "know-how" payments as payments for "knowledge, experience or skill." However, some types of know-how payment[91] are more akin to payments for services rendered and, as such, should be treated as business profits as being income "from the furnishing of services." This position was recognized in Rev. Proc. 69-19,[92] which posits a distinction between "service know-how" and "proprietary know-how" (payment for which constitutes a "royalty") and in the 1974 report of the fiscal committee of the OFCD,[93] which also recommended a

91. *E.g.*, payments under a technical assistance agreement.
92. 1969-2 C.B. 301.
93. Commentary 18 on art. 12, at 108 reads as follows:

> In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchiser imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various part of which it is being provided under the contract, and then to apply to each part of it so

breakdown between the two types, and separate taxation thereof under the business profits and the royalty articles respectively.

While income derived from the sale of goods is the paramount example of "business profits," quaere if the interest component of the sale price of the supplier, whether or not separately stated, who grants the buyer medium term credit. Should such interest component be separately taxed with source withholding? The convention is silent on this point as is the Treasury's Technical Explanation. It is likely that the U.S. Treasury would follow the recommendation of the 1974 OECD report that such interest whether or not separately stated be free from source taxation.[94]

The other provisions of article 6 set forth the deductions allowable in computing the net business income of the permanent establishment, imposing no geographic limitation on the place where such expenses are incurred.[95] As stated at article 6(2), the profits and deductions of the PE are computed on the basis of an arm's length relationship between the PE and the resident.

D. Investment or Passive Income

The general rule of taxation of passive income is withholding at the source, the rates of tax being lowered or eliminated by treaty.

1. Dividends

Article 9 distinguishes between portfolio investors, *i.e.*, those owning less than 10 percent of the capital stock of the payor corpo-

> determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part.

94. *Id.*, comment 24 at 95. Art. 11(3)(a) of the U.S.-Belgium convention of July 9, 1970, embodies this recommendation.
95. Art. 6(3).

ration and direct investors, *i.e.*, those owning at least 10 percent of the voting stock of the payor when not more than 20 percent of the income of such payor was of a passive nature.[96] In the case of a portfolio investor, the withholding tax on dividends is 15 percent, whereas dividends received by a direct investor are only subject to a 5 percent withholding tax. However, if the dividends are effectively connected with a permanent establishment, they are taxed as business profits.[97]

Following the source rule of IRC section 861(a)(2)(B), article 9(4)(b) provides that dividends paid by a foreign corporation will not be considered to be from U.S. sources, unless the foreign corporation has a permanent establishment in the United States and more than 80 percent of its gross income was attributable to the permanent establishment during the preceding three years.

Article 9 was amended by protocol signed October 12, 1970, effective for dividends declared on or after January 1, 1970, to extend to certain U.S. residents the benefit of a tax credit, avoir fiscal, introduced in French law in 1965. Thus, American portfolio investors and regulated investment companies, at least 80 percent of the stock of which is owned by U.S. residents receiving dividends from French corporations, will receive the same avoir fiscal that French investors receive and will be subject to a lower overall rate of tax on the dividends.[98] To obtain the refund of the avoir fiscal, a qualified U.S. investor need only file the requisite forms with the Office of International Operations of the Treasury Department.[99] In case the benefit of the avoir fiscal is not available to the U.S. resident shareholder and a précompte was levied on the dividend, the précompte will be refunded but tax will be withheld on such refund.[100]

96. Art. 9(1)(b)(iii).
97. Art. 9(3).
98. *See* the sample calculations in Statement of Assistant Secretary Cohen before the Senate Foreign Relations Committee, Nov. 19, 1971, on the Protocol with France, n. 8 *supra*.
99. *See* Rev. Proc. 73-34, 1973-2 C.B. 489.
100. *See* Art. 9(5).

2. Interest

Like dividends, interest is subject to a withholding tax in an amount reduced to 10 percent, provided such interest is not connected with a permanent establishment. In such case, the interest is taxable as business profits under article 6 of the convention.[101]

The term "interest" is defined very broadly in article 10(5) to include essentially any income deemed under the law of the source country to be income from money lent. A right to participate in the profits granted by the instrument creating the interest obligation does not change the characterization as interest.

The source rule of article 10(6) is substantially the same as that of IRC section 861(a)(1). Pursuant to this rule, if the payor has a permanent establishment in the country of source and the interest is borne by such permanent establishment, it is deemed to be from source in the country where such permanent establishment is situated.

Article 10(8) further provides that interest received by either government or their tax-exempt instrumentalities should be free from tax by the source country.

Lastly, a requirement of arm's length dealings in the determination of the interest rates is set forth at article 10(7). Only that part of the interest paid corresponding to arm's length interest is taxed at the reduced rate, the balance being taxed at nontreaty rates.

3. Royalties

The definition of "royalties" at article 11(4) includes patents, trademark, design, models, secret processes or formulae, and know-how royalties, *i.e.*, any payment for the use or the right to use the foregoing as well as any capital gains on sale or exchange of same if the payment of the gain is contingent, wholly or partly "on the

101. Art. 10(4).

productivity, use or disposition of such right in property."[102] The tax on such royalties is limited at 5 percent of the gross amount paid at the source.

However, royalties (including gains on sale or exchange) from artistic, literary, or scientific works are not subject to tax by the source country.[103]

As in the case of dividends and interests, the "effectively connected" principle applies to royalties as well as the arm's length requirement[104] and the source rule.[105]

4. Capital Gains

The general rule of article 12 is the absence of tax by the source country, unless the gain is effectively connected to either a permanent establishment or a fixed base in such source country. In addition, in the case of an individual, gains become taxable if he stays more than 183 days in the source country.

E. Personal Service Income

The convention distinguishes between two broad types of personal service income, dependent and independent personal service income.

1. Independent Personal Services

Article 14 provides that income from "independent activities" (*i.e.*, any activity "other than commercial, industrial, agricultural,

102. Art. 11(4)(b).
103. Art. 11(3).
104. Art. 11(7).
105. Art. 11(6).

carried on his own account independently by a person who receives the proceeds or bears the losses arising from" such activity[106]) is not taxable by the source country unless: (a) the recipient is present in the source country for more than 183 days in the fiscal year concerned; and (b) the recipient maintains a fixed base in the source country for more than 183 days in the fiscal year. The concept of "fixed base" is not defined in the convention but is derived from the 1963 OECD draft and it has been ruled to be similar to that of "permanent establishment."[107]

2. Dependent Personal Services—Article 15

Employment income with respect to employment exercised in the source country escapes taxation there if: (a) the recipient is present in the source country less than 183 days in the year; (b) the wages are not borne by a permanent establishment there; and (c) the employer paying, or on whose behalf the remuneration is paid, is not a resident of the source country.

3. Entertainers and Athletes

The Treasury Department has issued a series of rulings seeking to classify the taxation of artists and athletes under article 14, especially when the services are "loaned" to a corporation which may or may not be controlled by the artist or athlete.

Revenue Ruling 74-330[108] illustrates the factors indicating whether or not an employer-employee relationship exists between a foreign entertainer performing personal services in the United States and a U.K. corporation. As the language of the then U.K.

106. Art. 14(3).
107. Rev. Rul. 75-131, 1975-1 C.B. 389.
108. 1974-2 C.B. 278; *see also* Rev. Rul. 74-331, 1974-2 C.B. 282.

treaty was similar to that of articles 6 and 14 of the French convention, the holding of the Ruling is applicable here. The factors are control, duration of the contract between the entertainer and the corporation, veto arrangements, salary formula, and financial risks. The Ruling further provides that the most important factor is the right to control the performance of the services. If, for example, the corporation does not assume the financial risk of the performance or if the entertainer's salary is a percentage of the profits, then the services are not furnished for or on behalf of the corporation, and same is merely the entertainer's agent. The same principles were applied to boxers in Revenue Ruling 75-503[109] with respect to purses earned as a result of prize fights.[110]

F. Other Types of Income

Under article 20, only the payor country may tax Social Security payments when made to a resident of the other country.[111]

Pensions, annuities, and alimony are only taxable in the country of residence of the recipient (article 19).

Income from government functions (article 16) is not taxable by the State of residence unless the services are rendered in connection with a commercial activity of the Contracting State. Thus, an American citizen resident of France is not taxable in France on his income earned in France in the employment of the U.S. government.

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109. 1975-2 C.B. 352.
110. A purse from a prize fight is compensation for personal services. Rev. Rul. 70-543, 1970-2 C.B. 172, *amplified by* Rev. Rul. 73-107, 1973-1 C.B. 376
111. *Cf.* Rev. Rul. 75-489, 1975-2 C.B. 511.